# SOVEREIGN WEALTH FUNDS
## A great opportunity for the global financial world but a potential threat for both host country and home country

**By**

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Sovereign wealth funds are among the most important players in global financial markets, because of their increasing size and number. Both the global financial crisis and oil price crisis have confirmed this prominent status due to the resilience of sovereign wealth funds against these crises. Nevertheless, sovereign wealth funds recently caught the attention of many experts because of the shifting of their features from riskless assets and debts instrument to more risk-return profile assets.

Sovereign wealth funds, in fact, are large pools of capital created by governments to hold foreign assets in order to achieve long-term investments via a broad array of vehicles such a private equity funds, infrastructure, real estate, hedge funds and direct equity investments.

Specifically, sovereign wealth funds can be classified into five groups.[1]

First group represents the stabilization sovereign wealth fund. Stabilization funds' role is to protect domestic economy against commodities prices swings and external shocks. Stabilization funds are Kiribati Revenue Equalization Reserve Fund (1956), Nauru Phosphate Royalties Trust (1968), Botswana Revenue Stabilization Fund (1972), Tuvalu Trust Fund (1987), Colombia Oil Stabilization Fund (1995), Venezuela Stabilization Fund (1998), Azerbaijan State Oil Fund (1999), Iran Oil Stabilization Fund (1999), Peru Fiscal Stabilization Fund (1999), Algerian Revenue Regulation Fund (2000), Mexico Oil Stabilization Fund (2000), Sudan Oil Revenue Stabilization Account (2002), Russia Oil Stabilization Fund (2004), Timor Leste Petroleum Fund (2005), Mauritania National Fund for Hydrocarbon Reserve (2006), Chilean Economic and Social Stabilization Fund (2007), Trinidad and Tobago Heritage and Stabilization Fund (2007), Chad Revenue Management Plan (2008), Turkmenistan Stabilization Fund (2008) and Mongolia Fiscal Stability Fund (2011).

Second group stands for the savings sovereign wealth fund. Savings funds are designed for natural resources' income redistribution from current to future generation. Effective savings funds are Kuwait Investment Authority (1953), New Mexico State Investment Council (1958), Permanent Wyoming Mineral Trust Fund (1974), Singapore Temasek Holdings (1974), Abu Dhabi's Investment Corporation (1976), USA Alaska Permanent Fund (1976), Canada Alberta's Heritage Fund (1976), Brunei Investment Authority (1983), Government Investment Corporation of Singapore (1991), Botswana Pula Fund (1993), Malaysia Khazanah Nasional Berhad (1993), Gabon Sovereign Fund (1998), Fund for Future Generation of Equatorial Guinea (2002), Qatar Investment Authority (2005), Bahrain Future Generations

[1] The number into bracket is the creation date of the specific sovereign wealth funds.

Reserve Fund (2006), Libya Investment Authority (2007), Ghana Petroleum Fund (2011) and Panama Sovereign Wealth Fund (2012).[2]

Third group outlooks for reserve investment sovereign wealth funds. Reserve investment funds aim at managing foreign exchange reserves by allocating assets in higher yields investments, such as, equities and alternative instruments. Operational reserve investment funds are Kuweit General Reserve Fund (1960), Oman State General Reserve Fund (1980), Government of Singapore Investment Corporation (1981), International Petroleum Investment Company (1984), United States Alabama Trust Fund (1985), Mubadala Investment Company (2002), Korea Investment Corporation (2005), Ras Al Khaimah Investment Authority (2005), Investment Corporation of Dubai (2006), Oman Investment Fund (2006), Indonesia Government Investment Unit (2006), China Investment Corporation (2007), Emirates Investment Authority (2007), Abu Dhabi Investment Council (2007), France Strategic Investment Fund (2008), Russia Reserve Fund (2008), Italy Strategic Fund (2011), North Dakota Legacy Fund (2011), Kazakhstan National Investment Corporation of National Bank (2012) and Western Australian Future Fund (2012).

Fourth group denotes development sovereign wealth funds. Development funds are organized to achieve various domestic or foreign socioeconomic objectives namely infrastructures. Among development funds are Louisiana Education Quality Trust Fund (1986), Kazakhstan National Oil Fund (2000), Iraq Development Fund (2003), Vietnam State Capital Investment Corporation (2005), China-Africa Development Fund (2007), Saudi Arabia Public Investment Fund (2008), Iran National Development Fund (2011), Nigeria Sovereign Investment Authority (2011), Papua New Guinea Sovereign Wealth Fund (2011), Russian Direct Investment Fund (2011) and Fund Soberanu de Angola (2012).

Last Group concerns contingent pension reserve sovereign wealth funds. Pension reserve funds objective is to cover upcoming pensions cost or to finance government pension funds. Pension reserve funds include Korea National Pension Service (1988), Norway Government Pension Fund (1990), China National Social Security Fund (2000), Ireland Oil Stabilization Fund (2001), New Zealand Superannuation Fund (2003), Australian Future Fund (2006), Chilean Pension Reservation Fund (2006), Japan Government Pension Investment Fund (2006), Kazakhstan Samruk-Kazyna JSC (2008) and Russia Welfare Fund (2008).

Sovereign Wealth Funds, even if resources' rich countries mostly own them, provide significant benefits in advanced economies, emerging market economies, as well as in developing economies.

In the United States, their principal host country, sovereign wealth funds have helped keep long-term interest rates low, for so long, and improve access to capital for corporations, by their huge acquisition of United Stated treasury bonds. With a share of more than 90% invested, sovereign wealth funds remain the largest single investors in its financial institutions. United States economy benefited thus for more efficient risks diversification and resources allocation by the investments of sovereign wealth

[2] Kuwait Investment Authority was one of the first sovereign wealth funds created in 1953.

funds in their capital markets. Investments in banks, private equities and housing also help as sources of large inflow of liquidity in the economy. Consequently, during the global financial crisis, sovereign funds demonstrate their lead role in mitigating the adverse effects of a liquidity or credit crisis, by strengthening the vulnerable balance sheets of some of the world's largest financial institutions, and appearing as countercyclical providers of capital in the United States. Moreover, the real estate industry and the technology industry are respectively, the second and third most targeted investment sectors in the investments portfolios of sovereign wealth funds with sound macroeconomic outcomes. By investing in the United States real estate industries and technology sector, sovereign wealth funds help in creating and preserving employment, but also in enhancing economic growth.

In emerging market economies, the global financial crisis offered an opportunity to sovereign wealth funds to raise their participation and invest more in these economies. In the second half of 2010, more than half of publicly reported direct investments by sovereign wealth funds occurred in the Asia Pacific region, Brazil, Russia and India. Furthermore, as several new wealth funds have emerged in these regions, domestic investments have constituted increasing portions of their portfolios, leading to increased total investment. The key benefit of sovereign wealth funds in emerging market economies is thus the increasing reduction of infrastructures gap. The match between sovereign wealth funds' long-term investment horizons and the long-term nature of infrastructure investments supports their substantial investment in infrastructures projects in these regions. In this regards, some sovereign wealth funds are now considering development of domestic infrastructures as part of their core mandate.

In developing economies, sovereign wealth funds' benefits are three-fold. Primarily, sovereign wealth funds enable developing economies, most of which heavily relied on commodities exports, to diversify their income sources. Diversification allows the minimization of risk and does not leave developing economies completely exposed to the volatilities of commodities prices. As shown recently, when sovereign wealth funds offset the adverse effects of the collapse of international commodities prices in many developing economies. Secondly, the fundamental benefit of sovereign wealth funds in developing economies is the resolution of Dutch Diseases syndrome. Basically, sharp surge in prices of commodities exported tend to result in a boom in aggregate demand and a sudden upward swings in wealth, which induce a large inflow of foreign currency and thus a real exchange rate appreciation. The real appreciation via the spending effect weakens the competitiveness of non-commodity sectors in international markets. In addition, the resource movement effect leads to a shift of capital and labor in commodity sector experiencing an increase in demand. Sovereign wealth funds help thus developing economies experiencing boom in the commodity sector to maintain external stability over the long-term, by augmenting their net external asset position in a way consistent with their economy features. In addition, sovereign wealth funds dampen the loss of competiveness of non-commodity sectors and mitigate the macroeconomic risk associated with the real exchange rate appreciation, by accumulating more foreign assets proportionately to changes in commodity exports. Thirdly, by investing in foreign advanced economies like the United States, sovereign wealth funds give developing economies the

opportunity to access new skills, knowledge, and technology transfer to supplement their developments needs. That explained why, even sub-Saharan Africa markets that have historically struggled to manage natural resources' wealth are seeing the creation of various sovereign wealth funds.

Notwithstanding theses numerous benefits of sovereign wealth funds across the globe, they can potentially be made into threats both in host states and owned states.

In the host countries, namely, United States, many concerns are arising regarding the growing nature of sovereign wealth funds and the rebalancing of their structures of investments. In fact, sovereign wealth funds are deemed for opaqueness and limited disclosure in its key aspects including, objectives, holdings, governance and performance. Importantly, non-democratic resources' rich countries mostly own them. Hence it becomes obvious that, threats can be either political or related to security. In the political point of view, owned states with political ambitions such as accessing military technology, controlling strategic markets, or influencing public opinion, may direct their sovereign wealth funds toward protected and strategic stakes in some sectors within the host country, such as, military corporations, natural resource industries, or other politically sensitive sectors. In the security point of view, sovereign wealth funds with multiple investment objectives may take investment decisions in a fashion involving national security concerns.

In the owned countries, such as, resource rich-countries, sovereign wealth funds face many challenges. Mismanagement of sovereign wealth funds yields may sometimes lead to problems of severe economic distortions, endemic corruption, and rampant embezzlement. In some cases, large sudden payments into a domestic economy may trigger corruption and expropriation of wealth in countries with less developed legal and economic systems. Because of lacks in transparency on natural resource wealth that is unexpected, political interests may create internal pressures on sovereign wealth funds and may tend to crowd out spending from national interest into personal interests, and reduce the incentives to create employment and economic growth. The worst outcome of sovereign wealth funds threat may be that a select few elite in power, spends the country's wealth bouncily, disregarding future generations. These potential adverse effects of sovereign wealth funds can explain the impediments to the development of many African resources' rich nations.

To overcome these sovereign wealth fund threats, regulations for greatest operations of sovereign wealth funds have been developed. The International Monetary Fund has convened the International Forum of Sovereign Wealth Funds and its predecessor, the International Working Group of Sovereign Wealth Funds. The IMF thus unveiled the Santiago Principles designed to safeguard independence, transparency, accountability, and enhance governance of sovereign wealth funds. However, the Santiago Principles face some intrinsic inadequacies on their ability in fostering sovereign wealth funds.

The good news above all is that sovereign wealth funds still have a significant role in global financial stability and macroeconomic prospects throughout the world. To preserve and expand its benefits this thought brought four key recommendations. First, permanent and close collaboration between the IMF, the host countries and the owned countries are compulsory in the governance of sovereign wealth funds.

Second, strengthen regulations of sovereign wealth funds by enforcing the Santiago Principles and adding mandatory rules. Third, a coordination of sovereign wealth funds objectives and economic interests of host countries is needed. Fourth, sovereign wealth funds should operate in each host country, consistently with their national laws and national securities strategies.